

COMPARISON OF GLOBAL AND CROATIA AIRLINES PREMIUM AIR TRAVEL TRENDS

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ABSTRACT

Demand for airline premium travel has an influence on some airlines' pricing and operational strategies out of proportion to the number of travellers, thus supporting airline financial performance. The size and trends of world premium air travel and its dependence on economic changes for main traffic route areas are examined in the paper and compared with size and trends of Croatia Airlines premium air travel over the period of last decade. Also, the innovations in first and business class seating to further improve a flight experience are investigated and a trend of premium class seating moving upmarket is recognized. The paper reviews forces that affect demand for premium air travel and recovery patterns after recession and financial crises and assess the widely accepted assumption that premium travellers are inelastic with respect to fares. Analyses of premium air traffic data from IATA shows that whilst international long-haul premium traffic recovered quickly and robustly from the financial crisis - particularly that connecting advanced to emerging markets - short-haul travel demand has been more lagging. The paper brings some specific guidelines for airlines to keep and increase their premium travel volumes and improve their financial performance.

KEYWORDS:

Premium class travel, business passengers, low-cost airlines, passenger yield, Croatia Airlines

1 INTRODUCTION

With an increasingly globalized and financially integrated world economy, air transport services are essential for moving people and goods swiftly within and between nations, and the increased liberalization and deregulation of international air transport markets has facilitated this. Premium air travel is an important aspect of international trade and economic development. Over the period of last decade airlines have experienced many financial challenges, especially around 2008 when oil prices outstripped \$130/barrel causing a worldwide economic slowdown. Demand for airline premium travel is a key source of revenue and profit for many scheduled carriers and has an influence on some airlines' pricing and operational strategies out of proportion to the number of travelers.

Traditionally, airlines identify different segments of air travel market and offer appropriate fare products to each of them according to their price and time sensitivity. To achieve the required demand segmentation in practice, airlines physically differentiate their fare products by offering clearly identifiable different products with different quality of service, such as first class, business class, economy class and premium economy class.

The quality of business class products has increased in recent years while first class capacity is diminishing. At

the same time passengers are benefitting from airlines which invest more in premium economy amenities. Today's typical business class seat is lie-flat, often with direct aisle access, previously the main characteristics of traditional first class. The world's leading airlines are reducing first class space on their aircraft in favor of more business class and premium economy seats. A typical long-haul aircraft configuration with first, business and economy class is replaced by cabin arrangement with business, premium economy and economy class on numerous routes.

The aim of the paper is to examine and analyze trends in premium air travel and its dependence on economic changes for main traffic route areas are examined in the paper and compared with size and trends of Croatia Airlines premium air travel over the period of last decade.

2 RECENT CHANGES IN AIRCRAFT CABIN CONFIGURATIONS

Flexible aircraft cabins (the concept allows for seat pitch to be quickly increased), removal of overhead bins, foam seat cushions that allows passengers to adjust the firmness of their seat with the push of a button, introduction of in-flight social zones, suites with double beds, a smart seat which remembers passenger preferences are new trends in the evolution of aircraft cabin design that make air travel more

comfortable and familiar. Icelandair's Boeing 757 Hekla Aurora aircraft, Thomson Airways' 'Beach Snack Bar' concept, KLM's Boeing 787-9 business class, and Finnair's A350 XWB serve as insightful examples of how inventive cabin design can be used to enhance the in-flight experience [1].

2.1 First class

Number of revenue passengers who traditionally travel premium class is diminishing, as corporate and government travel policies approve travelling in higher classes for journeys under a certain length. Premium class passengers increasingly choose lower-cost options or travel by private jet. First class is often used for frequent flyer redemptions, or complimentary upgrades and it mostly exists not for direct revenue contribution, but for marketing purposes and boosting wider airline brand's credibility. In response, many airlines are shrinking their first class cabins to two rows or phasing out first-class cabins entirely. At the same time, carriers are offering more luxury facilities like world-class gastronomic experiences and improved sleep quality to differentiate between first class and business class. However, some airlines like Singapore Airlines, whose luxurious first-class service has long been part of its marketing, stick to first-class cabins, and make them even richer. Their large suits look like flying hotel rooms but their number is significantly reduced. Singapore Airlines markets its highest class on its A380s as "suites", with the tagline "A class above first." Etihad Airways introduced a three-room suite called "The Residence" in December 2014 when it added the Airbus A380 to its fleet.

But, even Emirates decreased the number of first class seats, although persisting with first class. Qatar Airways, known for its premium position, has first class only on its small A380 fleet but its business class product is more like first class product of other airlines.

2.2 Business class

The group of passengers travelling in the business class cabin is not uniform and a careful market segmentation is essential to understand passenger demands. According to Claussen and O'Higgins (2010), five distinct groups can be identified as potential clients for business class travel:

1. Upgraders -i.e., leisure travelers likely to switch from economy to business class, highly sensitive to prices and less time sensitive,
2. Affluent individuals who are looking both for attractive pricing and schedules,
3. Self-employed who are looking for a good quality/price trade-off and would change their schedule preferences for cheap offerings,
4. Corporates I – medium to high level executives who require frequency, a strong network, a high-quality product, and are insensitive to price,
5. Corporates II – low level executives who travel in the business class cabin only if the price is especially reasonable [2].

Doganis (2002) clustered five groups of factors important in the value propositions of the business class target group: price, schedule, comfort, convenience, and image [3].

Traditionally, business-class cabin is separated from the economy class cabin and equipped with more comfortable and functional seats, from cradle seats with around 150-160 degrees of recline, which are still common on shorter routes, to fully flat seats and separated cabin seats on long haul business class flights.

Business class has started to disappear from some short/medium haul routes, to be replaced with full fare economy and discount economy. On these routes, the seats are the same for all passengers, only the flexibility of the ticket and the food and beverage service differs. On shorter routes (less than one hour) many airlines have removed business class entirely.

2.3 Premium economy class

Although premium economy class is part of the economy class, some important advances related to that travel segment are further considered. Airlines bring business-class service elements to premium economy class to attract more travellers and to maintain competitive advantage in today's air transportation market. It provides a larger and more comfortable seat than standard economy class and is cheaper than business class. On international flights, premium economy usually amounts to what business class used to be.

Hugon-Duprat and O'Connell (2015)'s findings show that the unit costs to produce a premium economy seat is only 1.6 times more expensive than an economy seat but it generates revenues that are 2.3 times higher than its cost of production. Premium economy generates the highest marginal revenues over its cost of production when benchmarked against the other cabins [4].

The study conducted by Kuo and Jou (2017) used spike model to investigate how much extra air travellers are willing to pay to upgrade to premium economy class. Three flight distances, short, medium, and long hauls were separately estimated to investigate the effects of flight distance on willingness to pay. Travelers' willingness to pay to upgrade from economy class to premium economy class round-trip was US\$138, US\$309, and US\$545 for short-haul, medium-haul, and long-haul, respectively [5].

3 PREMIUM TRAVEL DRIVERS

Since international air passengers travelling on premium seats represent 8% of traffic but 26% of passenger revenue, the premium travel segment is broadly recognized as an important travel market segment, particularly for hotels and network airlines, but also for others in the travel and tourism value chain. [6].

According to research done by IATA [6], there is a positive relationship between the number of premium

passengers travelling between a country pair and the size of the economies at either end of the route. Still, some interesting country-pairs are found as outliers to that relationship: those with a relative small number of premium passengers but large economies at both origin and destination (such as United States - Russia) and those with a high number of premium travellers but small economies (such as United Arab Emirates-Bahrain).

The same research identified the following factors as the most important business travel drivers determining the size of premium travel markets between country pairs:

- the relationship between travel and distance (business travel, all other things being equal, tend to diminish with distance)
- historical relationship (for example, premium travel market between Australia and the United Kingdom is about 3 times larger than Singapore - United States)
- regulatory framework of a country (how well property rights are protected and the cost of setting up a business)
- the quality of the information communication and technologies infrastructure
- price competitiveness (purchasing power parity, airfare ticket taxes, taxation level in the country).

Many countries have a great potential to increase the number of business travellers over and above the flows implied by economic size and distance, by improving one or several of these drivers. Basic findings of IATA's research could be summarized as follows [6]:

- economic size at both origin and destination is the most significant factor in explaining differences between country-pairs
- all other things being equal, if GDP rises by 10%, number of business passengers will increase by 6%
- any 10% improvement in policy rules and regulations, ICT infrastructure and price competitiveness would lead to an increase of

4.5%, 2.2% and 13.8% in number of business travellers

- for every 10% increase in distance between economies, premium travel markets, all other things being equal, will be 9% smaller.

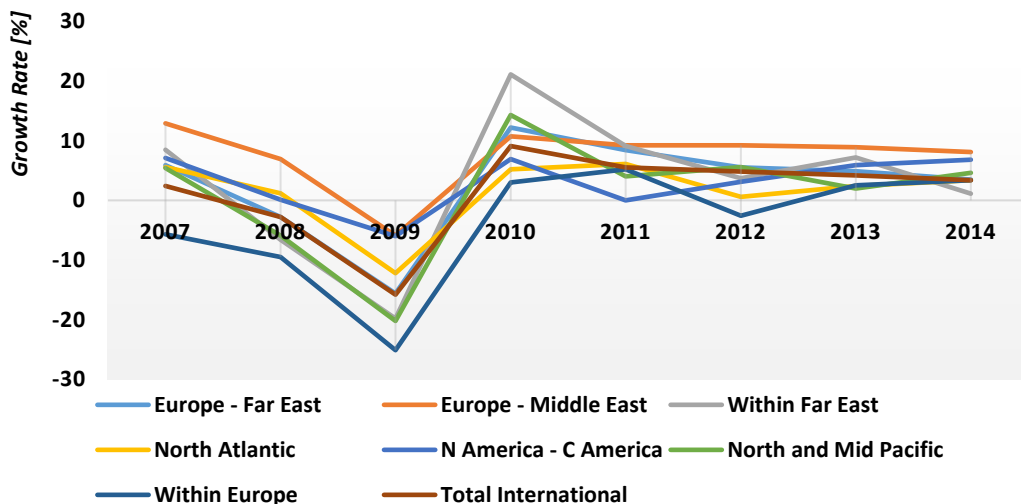
4 ANALYSIS OF PREMIUM TRAFFIC TRENDS OVER THE PAST DECADE

This chapter provides an analysis of high-yield traffic growth based on IATA Premium Monitor reports from January 2008 to December 2015 and IATA Airlines Financial Monitor reports from 2014 to 2018.

4.1 Premium traffic trends over the period 2007-2014

The slowdown in premium travel was widespread across the world even through most of 2007 especially in markets linked to the troubled US economy. It was partially neutralized with the impact of Open Skies across the North Atlantic which provided the introduction of new services and brought increased competition resulting in premium revenues slowing more sharply than volumes. Another boost to the premium travel market was provided by the services offered on many long-haul markets by the Middle Eastern airlines and Middle Eastern hubs [7].

According to IATA, international premium traffic began to fall in July 2008 and the monthly traffic decline has been particularly steep since November 2008, leading to a 21% fall in premium passengers worldwide in February 2009 compared with February 2008 [8]. Premium passenger traffic data provided by IATA Premium Monitor reports from January 2008 to December 2015 were deeply analysed and growth rates for major routes over the 2007-2014 period are illustrated in Figure 1.



Source: Airlines Premium Traffic Monitor, January 2008-January 2015

Figure 1: International Premium Traffic Growth by Route 2007- 2014

Premium travel fell sharply from September 2008, as the Lehman Brothers bankruptcy marked the start of the collapse in the banking sector. Business travel, being highly sensitive to economic growth and developments in international trade and investment was so far less sensitive to fare levels. The fact that average premium fares were falling faster than discounted economy fares on some markets, e.g. within Europe, witnessed about severity of the downturn in business travel during 2008. For network airlines, focused on serving this passenger segment, the decline in premium revenues damaged overall profitability [9].

The year 2009 saw a 16% fall in premium travel numbers. The decline in premium travel matched very closely the decline in world trade so when world trade started to pick up at a robust pace from the middle of 2009, premium passenger numbers followed that upturn very closely. A steady shift of business travelers from premium to economy seats on the within-Europe market was recorded, but this was less evident on long-haul markets. There were large geographical differences in passenger growth. Very strong growth was recorded in Within-Far East and Asian markets, while the weakest large premium market was within-Europe where premium travel numbers were down on the previous year by 25% [10].

Over the 2010, premium travel continued to grow and premium travel markets expand by 9.1% [11].

During the 2011, premium travel markets grew slowly by 5.5%. While first 8 months saw a nearly flat trend, premium travel strengthened at the end of 2011 [12]. Growth on all the larger routes continued at a robust pace with no significant areas of weakness.

During 2012, expansion in economy and premium travel numbers slowed from the faster growth trend seen in late 2011. For the whole year, premium travel expanded 4.8%. Among the major markets, air travel across the North Atlantic and within Europe experienced largest decline in 2012. Recession in many European economies contributed to premium travel numbers expanding for only 1.0% within Europe. By contrast, Far East contributed more than any other market to overall growth in premium travel in 2012 [13].

The growth trend continued in 2013 with number of passengers travelling in premium seats on international markets expanded by a solid 4.2% mostly due to positive developments in the business environment in the second half of the year. The largest share of the rise in premium travel in 2013 was attributed to the within Far East market which expanded 7.2% in 2013 [14].

In 2014, annual growth was 3.4% for premium international air travel and 3.5% for economy class. While in 2013 and during first months of 2014 premium travel expanded at a faster pace than economy travel, in 2014 there has been no further gain in premium's share of total traffic [15].

The impact of the global recession of 2008 – 2009 on premium and economy travel was remarkably different.

Premium traffic started to fall before economy traffic, as corporations anticipating the recession started to cut travel budgets. While economy traffic recovered strongly a year after the worst negative growth rates were recorded, premium traffic needed years to stabilize growth rates and grew slower than economy traffic for many years. Economy travel regained its pre-recessionary levels in early 2010, but premium traffic did not recover to these levels until late 2012.

4.2 Premium traffic trends over the period 2015-2017

In 2013 and early 2014, premium travel was expanding at a faster pace than economy travel which was positive for airline yield growth and revenues. That trend reversed in 2015, with relatively stronger growth in economy class travel. Premium traffic volumes grew by an estimated 3.7% in 2015 thanks to upward trend recorded in the first months of 2015. The easing in the upward trend of premium traffic over the second half of 2015 relates to broad-based weakness in the drivers of premium travel demand, including the ongoing uneven pattern of global economic growth and the emergence of key economic risks. Comparatively strong economic performance in advanced economies has supported premium traffic on the North Atlantic, but slowing growth in a few large emerging markets such as China and Brazil, has weighted on premium traffic growth in many markets [16].

According to IATA Airlines Financial monitor issued in February 2017, premium's share of revenues increased on many key routes thus supporting airline financial performance. Still, average passenger yields have trended downwards since late-2014, and fell by 8.8% in 2016 compared to the previous year. The main reason for these developments lies in upward trend in oil and jet fuel prices and rising labor costs in some key markets. Industry-wide passenger yields have trended downwards since late-2014, and fell by 8.8% in 2016 compared to the previous year [17].

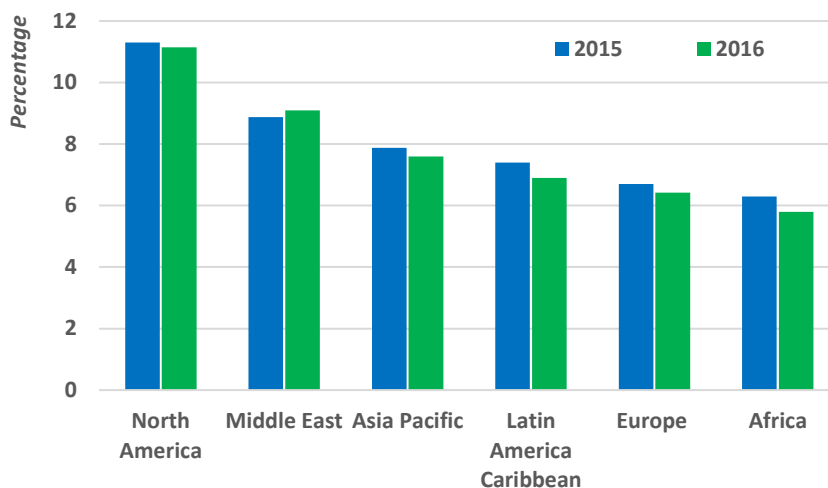
International passenger traffic by cabin class and geographic region for 2016 are reported in Table 1. Figure 2 shows how the share of premium international traffic varies by region.

Passenger and freight volumes grew by 7.6% and 9.0% respectively in 2017 as a whole and are both carrying solid momentum into 2018. The passenger load factor posted a record high for a calendar year in 2017 (81.4%), while the freight load factor climbed by 2.5 percentage points compared to 2016. Stronger global trade conditions have helped to support premium-class demand. Premium's share of total international passenger revenues increased to 27.0% in the first 11 months of 2017, up from 25.9% for the same period in 2016 [18].

Table 1: International Passenger Traffic by Cabin Class

Region of Airline Domicile	RPKs ¹ (millions)					
	Premium Classes ²		Economy Classes		Total	
	2016	% Growth	2016	% Growth	2016	% Growth
Africa	8,059	0.7	128,787	10.7	136,846	10.1
Asia/SW Pacific	100,905	5.3	1,215,024	10.9	1,315,929	10.4
Europe	109,757	1.4	1,582,658	5.8	1,692,414	5.5
Latin America	13,596	2.0	179,427	8.8	193,023	8.3
Middle East	60,634	12.6	597,108	11.7	657,743	11.8
North America	64,488	1.1	508,380	4.1	572,868	3.7
Industry	357,438	4.2	4,211,384	8.1	4,568,822	7.8

Source: IATA WATS (World Air Transport Statistics) 2017, IATA, Montreal 2017, p. 47

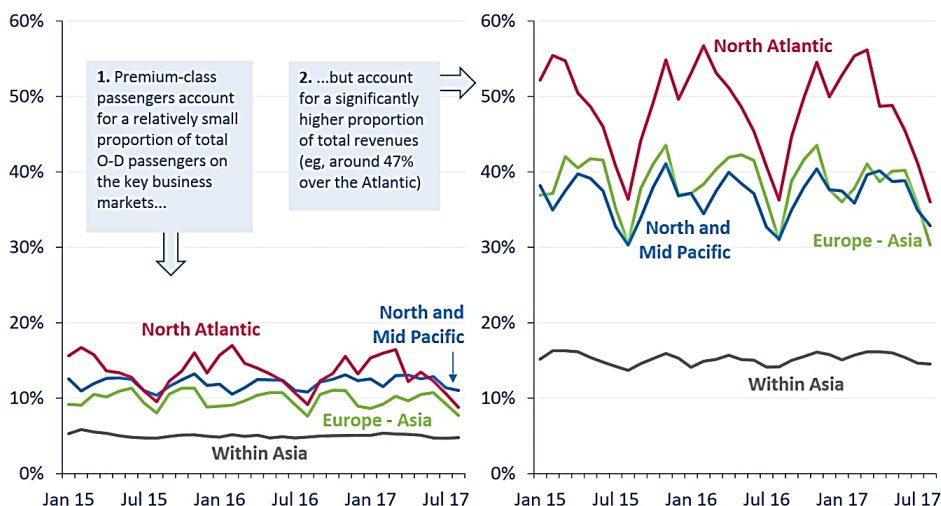


Source: IATA WATS (World Air Transport Statistics) 2017, IATA, Montreal 2017, p. 48

Figure 2: Share of Premium International Traffic, 2015–2016

Before the recession, premium passengers represented around 9.5% of total passengers, while in the 2016 it was around 7.8%. Given that premium fares are much higher than economy fares, the loss in revenue is

significant. Figure 3 highlights the differing importance of premium - class demand over time on four key markets, which together account for more than 60% of all international premium revenues.



Source: IATA Economics' Chart of the Week, 10 November 2017, available at: <http://www.iata.org/publications/economics/Reports/chart-of-the-week/chart-of-the-week-10-Nov-2017.pdf>

Figure 3: Premium Class Share of Total Passengers and Revenues

¹ RPKs-revenue passenger kilometres

² Traffic for the premium classes refers to the combination of First Class and Business Class. Premium Economy (or similar) classes are included under Economy Class.

As shown in the left - hand graph, the premium cabin's share of total passengers ranges from around 5% on international routes within Asia to nearly 13% across the North Atlantic. As the right - hand graph shows, premium travel accounts for close to 15% of total revenues within Asia, around 37% between Europe and Asia and across the Pacific, and almost 47% across the North Atlantic [19]. The long-standing downward trend in passenger yields started to level off during the middle of 2016 (Figure 4).

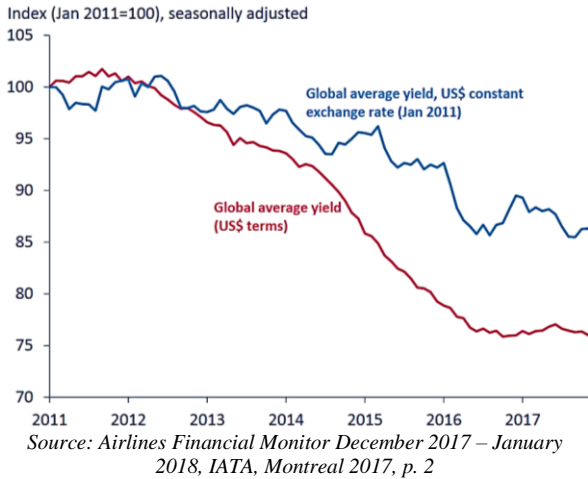


Figure 4: Airlines' Global Average Yield

Source: Airlines Financial Monitor December 2017 – January 2018, IATA, Montreal 2017, p. 2

Yields in exchange-rate adjusted terms trended downwards modestly during the second half of 2017, but the key point is that yields remain broadly unchanged in year-on-year terms. The change in trend in the yield series has come alongside a strengthening in the global economic backdrop, as well as upward

pressure on some key input costs, including oil and labor [18].

5 CROATIA AIRLINES PREMIUM AIR TRAVEL TRENDS

Croatia Airlines does not offer first class travel on any of their flights. Business class is available on all Croatia Airlines flights. Its fleet consists of Airbus A320, Airbus A319, Q400 aircraft, as well as Bombardier CRJ-1000 aircraft that are wet-leased from Air Nostrom and operated during busy summer months. Business class is dedicated to the first three rows of the aircraft, however, it may be contracted or expanded depending on demand. Although Business class seating has the same seat pitch as Economy (32 inches), the airline blocks out the middle seat in rows of three to create additional space.

On all Croatia Airlines flights passengers are offered free food and beverages which vary depending on the class of travel, the flight duration and the part of the day. As of 30th November 2016, in the scope of the project "Inspired by Croatia", traditional food is offered to business class passengers. In cooperation with their partners, Croatia Airlines offers its business class passengers the possibility to rest in comfortable lounges at all its destinations.

Figure 5 shows share of premium class domestic and international passengers over the 2006-2017 period. Share of premium class passengers is higher among domestic passengers than among international passengers for considered period. Comparison of Croatia Airlines and European scheduled airlines premium travel data show that Croatia Airlines premium travel lags behind its European counterparts.

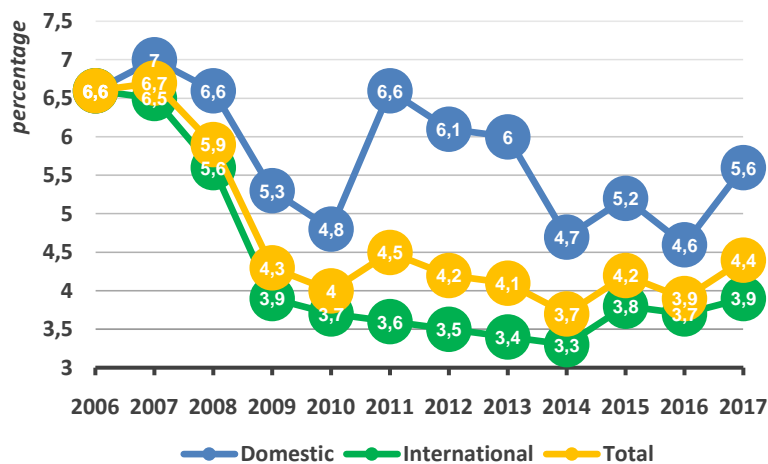


Figure 5: Croatia Airlines Premium Passengers Share

6 CONCLUSIONS

Passenger air travel is expected to maintain positive growth rates, despite a number of challenges faced by the industry. The rapid growth of passenger numbers across the world is likely to influence the way airlines

consider their class distinctions. As premium economy and business classes improve, airlines will have to do more for their first class customers to make it worth its price.

Airlines are competing for premium class passengers through better differentiation of premium class

products, advanced cabin designs and better airport amenities. Premium travel demand tends to be highly correlated with world economic performance. The 2008-2009 slowdown in the economy has led to a reassessment of the assumption that business or time sensitive passengers are inelastic with respect to fares and that they would be prepared to pay high fares for attractive flight schedules and frequencies, flexibility and comfortable seats. Analyses of IATA premium air traffic data shows that whilst long-haul (intercontinental) premium traffic recovered quickly and robustly from the financial crisis short-haul travel demand has been much more sluggish.

To avoid decrease of premium passenger travel and improve their financial performance airlines should understand and recognize all relevant factors that drive demand for premium market segment, stop taking premium class passengers for granted, capture rich data about passengers' preferences at each point of interaction between the passenger and the airline to better understand their expectations and ensure their loyalty. Recent trends show that premium's share of revenues increased on many key routes thus supporting airline financial performance. When compared premium travel statistics in Croatia Airlines and in Europe, it is evident that Croatia Airlines premium travel lags behind its European counterparts with higher share of premium class passengers among domestic passengers than among international passengers.

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